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IN THE

Supreme Court of the United States

OCTOBER TERM, A.D. 1950.

UNITED STATES OF AMERICA,
Petitioner,

vs.

ELLIS R. LEWIS,
Respondent.

On Petition For a Writ of Certiorari to the United States Court of Claims

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BRIEF FOR RESPONDENT IN OPPOSITION.

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Opinion Below.

The special findings of fact, conclusions of law, and opinion of the Court of Claims (R. 4-11) together with the dissenting opinion of Judge Whitaker (R. 11-13) are not yet reported.

Jurisdiction.

The jurisdictional requisites are adequately set forth in the Petition.

Question Presented.

The question presented is not adequately stated in the Petition.

The question presented is: Where, as the result of a mistake, the respondent, who was in complete charge of the operations of his corporation-employer, directed the payment to himself and received, as part of his compensation for 1944, a bonus in excess of that to which he was entitled, and the excess bonus mistakenly paid was repaid by the respondent to his employer in 1946, pursuant to a court decree which found that the excess bonus had been paid by mistake and ordered its repayment, and the employer in 1945 filed an amended income tax return for 1944, in which it deducted only the amount of bonus to which respondent was entitled, and paid the additional 1944 tax, plus interest, due by reason of not deducting in the amended return the excess bonus, is the excess bonus mistakenly paid to the respondent excludable from his income for 1944, and should the tax paid by the respondent on account of said excess bonus be refunded to him?

Statute Involved.

The pertinent provisions of the Internal Revenue Code are set forth in the Petition (p. 2).

STATEMENT.

This is a suit for refund of income taxes paid for the calendar year 1944, and interest and penalty assessed and paid by reason of a late payment of part of said taxes.

The statement made in the Petition is substantially correct. There are a few inaccuracies and omissions in said statement which will be corrected here.

It is not correct to say that the president of respondent's employer (the "Company") "did not participate substantially in the management of the business" during 1944 (Petition, p. 3). The fact is that the president of the Company was in Florida during the year 1944, and during no time in that year participated in the conduct of the business of the Company other than to have one or two telephone conversations with the respondent and two meetings with the respondent, once in New York City and once in North Carolina (R. 5-6).

The essential facts with respect to the overpayment of respondent's bonus due to a mistake are as follows:

During the year 1944, the respondent's compensation agreement with his employer was that the respondent was to receive a salary and in addition thereto a bonus of 10% of the net profits of the company. In fact, the agreement was that, for the purpose of computing respondent's said bonus, "net profits" were the net profits of the Company *after* deducting therefrom federal income taxes thereon (R. 7, 9). The bonus to which respondent was entitled, computed in accordance with said agreement, amounted to $11,067.94.

The respondent erroneously and mistakenly believed and understood said agreement to be that, for the purpose of

computing the respondent's said bonus, "net profits" were the net profits of the Company *before* deducting therefrom federal income taxes thereon (R. 6, 7, 9). Pursuant to such mistake of fact as to said agreement, the respondent, as the active head of the Company, directed the payment, and received from the Company, as part of his compensation for the year 1944 a bonus in the sum of $21,924 computed on net profits before deducting therefrom federal income taxes thereon, which said bonus was $10,856.06 in excess of the amount to which he was entitled from the Company for said year under said agreement as it actually was (R. 6, 7).

The Company, when it filed its original income tax return for 1944, which tax it paid, deducted, as part of the compensation paid to the respondent, the sum of $21,924, the bonus paid to the respondent as the result of said mistake of fact (R. 6, 7). In 1945, the Company filed an amended return, in which it deducted, as compensation to the respondent, only the sum of $11,067.94, the bonus correctly computed and to which the respondent was actually entitled, and it paid the additional tax due from the Company under said amended return (R. 6).

In a suit in the Circuit Court of Cook County, Illinois, between respondent and the Company, the Court found, in December, 1946, as of November, 1946, that the agreement between respondent and the Company was that the respondent's bonus should be computed upon profits *after* taxes, that respondent erroneously believed and understood that the bonus was to be computed *before* deduction of taxes, and that by virtue of this mistake respondent received the sum of $10,856.06 in excess of the amount to which he was entitled under the agreement; and said Court, in its decree, entered a judgment against the respondent for said amount and the respondent, pursuant to said decree, refunded said money to the Company in 1946 (R. 7, 9).

ARGUMENT.

The situation presented by this case is that of a claim by a taxpayer for a refund of that part of his 1944 income taxes, which he paid because he included in the income for that year an excess bonus to which he was not entitled and which he received as a result of a mistake, and which he refunded in 1946. The sole question is: Was that excess bonus taxable income for 1944? If it was not, the decision of the United States Court of Claims is correct and the Petition for Certiorari should be denied.

I.

The Decision Below Is Clearly Correct.

The petitioner's sole claim is that the respondent received the excess bonus in 1944 under a claim of right; that therefore the so-called "claim of right" doctrine applies to this case and under it the respondent is not entitled to a refund of the income taxes he paid for 1944 on the excess bonus.

In asserting this position, petitioner ignores the fundamental fact that the respondent, when in 1944 he received the excess bonus, was not entitled to it and that he received it because of a mistake. This fundamental fact makes the so-called "claim of right" doctrine inapplicable to this case, and entitles the respondent to a refund of the income taxes paid by him on said excess bonus. This Court has so held. Other courts have so held. Reason and every principle of equity support that conclusion.

It is true that when the respondent received the excess bonus he believed that he was entitled to it. But the

existence of that belief does not bring this case within the "claim of right" doctrine, although the petitioner apparently bases its case entirely upon the fact of said belief. The important fact, distinguishing this case from those cases where the "claim of right" doctrine applies, is that, at the time respondent received the excess bonus, he was *not* entitled to it and it was paid to him and he received it because and as the result of a mistake. Therefore, although the respondent got physical possession of the excess bonus in 1944, it never belonged to him, he never had any right to it and it was not part of his 1944 taxable income. The principles governing this situation were clearly set forth by this Court in the case of

Freuler v. *Helvering*, 291 U.S. 35.

In that case this Court held that, where beneficiaries of a trust had been paid the entire income therefrom, and thereafter a court having jurisdiction over the trust had determined that the trustee should not have distributed the entire income, but, even though the trust instrument made no mention thereof, he should have withheld a portion thereof on account of depreciation, and ordered the repayment by the beneficiaries of the amounts received by them which should have been withheld on account of depreciation, such excess was properly not reported as income by the beneficiaries. This Court was of the opinion that, since it had been determined that the excess should never have been paid to the beneficiaries, that they were not entitled thereto and that they were obligated to repay the same, it did not come within the concept of taxable income.

This Court said (p. 42):

> "* * * The test of taxability to the beneficiary is not receipt of income, but the present right to receive it. Clearly an overpayment to a beneficiary by mistake of law or fact, would render him liable for the taxable year under consideration, not on the amount paid, but on that payable."

The dissent of Justices Cardozo, Brandeis and Stone in that case was not based on any dissent from the principle announced above, but on the position that the beneficiaries had not in fact repaid to the trustee that part of the income to which the beneficiaries were not entitled. The principle determining the case and which is determinative of the instant case was approved in the dissenting opinion.

In the instant case, the respondent paid the tax on the excess bonus in 1945, when he paid his 1944 income tax, and in 1946 repaid in full to the Company the amount of the excess bonus.

The *Freuler* decision, which was decided by this Court subsequent to the case of *North American Oil* v. *Burnet*, 286 U.S. 417, which case is the main reliance of petitioner, has been completely ignored by the petitioner in its Petition for Certiorari, although the *Freuler* decision was discussed at length and relied upon in the opinion of the Court below.

There are numerous other authorities which sustain the principle laid down by this Court in the *Freuler* case. Some of these are:

Knight Newspapers, Inc. v. *Commissioner*, 143 Fed. (2d) 1007 (C.C.A.-6, 1944).

Commissioner v. *Turney*, 82 Fed. (2d) 661 (C.C.A.-5, 1936).

Buder v. *United States*, (not officially reported), Case No. 11718, U.S.D.C., E.D. Mo. (1941), 41-2 USTC ¶9513, 40-1 USTC ¶9477, *app. dism.* 116 Fed. (2d) 284.

Ford v. *Nauts*, 25 Fed. (2d) 1015 (U.S.D.C., N.D. Ohio, 1928).

As we have said, petitioner primarily bases its position

on certain language in the opinion of *North American Oil* v. *Burnet*, 286 U. S. 417. The Court below said that this language was *obiter*.

In the later case of

Commissioner v. *Wilcox*, 327 U. S. 404,

this Court in language, which was not *obiter*, stated the correct rule explicitly. In that case Wilcox had embezzled certain funds from his employer, later gambling and losing them. He failed to report the embezzled moneys as income, and the Commissioner sought to assess a deficiency. This Court held that the embezzled funds did not constitute income within Sec. 22(a) of the Internal Revenue Code, which is the statute here involved. This Court rejected the Commissioner's contention that the "claim of right" doctrine was applicable and concluded that the correct rule was (p. 408):

> "that a taxable gain is conditioned upon (1) the presence of a claim of right to the alleged gain and (2) the absence of a definite, unconditional obligation to repay or return that which would otherwise constitute a gain."

Under the facts in the instant case, the "claim of right" doctrine is not applicable because neither of the tests laid down in the *Wilcox* case has been met.

First, there was no presence of a "claim of right" to the excess bonus. Petitioner attempts to make it appear that when the excess bonus was paid and received the correct amount was in dispute. Such was not the fact. The excess bonus was paid under the mistaken belief by both the respondent and the Company that the respondent was entitled to it. The belief of the respondent and the Company that respondent was entitled to the money, being based upon a mutual mistake, is not a "claim of right" by respondent at all. The mistake has the effect of nullifying the supposed claim of right.

Second, there was a definite unconditional obligation on the part of the respondent to repay or return the excess bonus, which obligation arose at the moment he received the bonus.

One who receives money under a mistake is subject to such obligation.

Leather Manufacturers' Bank v. *Merchants' Bank*, 128 U.S. 26.

Poindexter v. *The Equitable Life Assurance Society*, 127 W.Va. 671.

5 *Williston on Contracts* (Rev. Ed.), § 1574 and cases there cited.

American Law Institute, *Restatement of Law of Restitution*, §§ 18, 20.

In the *Leather Manufacturers' Bank* case, this Court held that, if a bank, upon which a check is drawn payable to a particular person or order, pays the amount of the check to one presenting it with a forged endorsement of the payee's name, both parties supposing the endorsement to be genuine, a right of action to recover back the money accrues at the date of the payment, and the statute of limitations begins to run from that date.

In the *Poindexter* case, excess premiums were paid to an insurance company as a result of the mutual mistake of the insured and the insurer. The Court said (pp. 681-682):

> "The payment and receipt of these excess sums was a purely mutual mistake, raising no blame against either party. * * * The insured had the absolute right to recover these excess payments from the instant they were paid, and the insurer the duty, equally absolute, to repay them. Thus stood their rights immediately after the payments."

In order to avoid the consequence of *Commissioner* v.

Wilcox, 327 U.S. 404, the petitioner has contended (Petition, p. 8) that the respondent's obligation to repay the excess bonus arose for the first time when the Circuit Court of Cook County entered its decree. This contention is erroneous. All the facts which fixed the rights and obligations of the parties occurred in 1944. The decree of the Circuit Court was simply declaratory of the direct, unconditional obligation which came into existence in 1944, at the moment the excess bonus was received by the respondent, and not in 1946, when the Circuit Court decree was entered.

Analogous situations are innumerable. For instance, if a statute is declared unconstitutional and void by a court of last resort, there is no doubt that the statute was void from the date of its enactment. Likewise, there is no doubt that, if a contract is declared void because it is against public policy, it was void from its inception.

The refund provisions of the Internal Revenue Code present similar instances: In 1944, A receives money which he erroneously and mistakenly believes is income and reports it as such. In 1946, the Commission of Internal Revenue determines that the transaction was a gift and not income to A. Would the Commissioner have any hesitancy in refunding the excess income tax paid by A for 1944? Or to state the converse situation: In 1944, A receives money which he honestly believes is a gift and, therefore, does not report it as income for 1944. The Commissioner in 1946 concludes that the money received by A in 1944 was not a gift, but was income. A, accepting the decision of the Commissioner, desires to report the money received as income in 1946, when it was determined that it was income and not a gift to him. Would the Commissioner permit A to do this? He would not. He would insist that A report the money received as part of his 1944 income and pay an additional tax for 1944.

The Court of Claims has consistently taken the position that one who receives money as the result of a mistake of fact is, at the time he receives it, under the definite, unconditional obligation to repay or return it; that the "claim of right" doctrine does not apply to such a situation; and that money so received and later repaid or returned, is not taxable income.

Lewis v. *United States*, (R. 4-13);
Greenwald v. *United States*, 102 C. Cls. 272;
Gargaro v. *United States*, 109 C.Cls. 528 (1947), 114 C.Cls. 704 (1949).

This, we submit, is the correct rule of law and follows the rule explicitly laid down by this Court.

II.

There Is No Actual Conflict In The Decisions.

There is only an apparent and not an actual conflict of authority in the decisions of the federal courts. This Court held unequivocally in the case of *Freuler* v. *Helvering*, 291 U.S. 35, that an overpayment to a person because of a mistake of law or fact would not make him liable for income tax in the year he received the overpayment and that income taxes would not be due on the amount paid, but on the amount actually payable, *i. e.*, the correct amount, excluding the overpayment made by mistake.

In the case of *Commissioner* v. *Wilcox*, 327 U.S. 404, this Court stated the principles of law which govern this case and which were applied by the Court below. Therefore, no new principle of law or no actual conflict as to the law is presented to this Court for decision by the Petition in this case. There may be decisions in the lower federal courts due to difference in applying principles of law to different facts. That divergence does not call for this

Court to review this case for the purpose of restating principles of law which it has already clearly stated. Nor does the fact that some courts have misinterpreted or failed to apply the principles of law announced by this Court create a conflict in the decisions of the federal courts which warrants the granting of a Petition for Certiorari.

The Court in the case of *Haberkorn* v. *United States*, 173 Fed. 2d 587 (C.A. 6, 1949) did say that a different rule than the one it used had been applied by the Court of Claims, and the Court of Claims in the opinion below said that it was aware that in the *Haberkorn* decision, upon similar facts the Court reached a contrary conclusion. However, we respectfully suggest that there is no real conflict to be resolved by this Court, because the Court of Claims has followed the principles of law laid down by this Court, while the *Haberkorn* case has ignored the principles laid down in *Freuler* v. *Helvering*, 291 U.S. 35, and has concluded that the principles of the *Wilcox* case were not applicable to the facts in the *Haberkorn* case. Neither in the District Court (78 F. Supp. 192, U.S.D.C., E.D. Mich., 1948) nor in the Court of Appeals, in the *Haberkorn* case, was the decision of this Court in *Freuler* v. *Helvering*, 291 U.S. 35, discussed or even mentioned. The Court of Appeals did discuss the case of *Commissioner* v. *Wilcox*, 327 U. S. 404, and that discussion shows that the *Haberkorn* case does not present a conflict of law with the decision of the Court below in this case. The Court in the *Haberkorn* case said the rule announced in the *Wilcox* case was not applicable to the facts in the *Haberkorn* case because the obligation of Haberkorn to repay the money he received in 1942 did not arise when he received it, but in 1944 when, apparently, he agreed to repay it. In the words of the Court (p. 590):

> "Subsequent developments in a later year gave rise to the obligation to repay it."

It thus appears that, so far as the rule in the *Wilcox* case is concerned, the *Haberkorn* case does not sustain petitioner's position here and presents only a different set of facts from that in the instant case and not a principle of law conflicting with the principle which, respondent submits, applies in the instant case.

III.

This Case Presents No Important Question Of Federal Law.

Respondent suggests that, although the result of this case is of financial importance to him, the case is of little importance otherwise. No vital or fundamental question of law is involved. This is apparent from petitioner's own conduct. Petitioner says that the principle of law applied by the Court below, and which it says is erroneous, is identical with that announced by the Court of Claims in two previous cases, *Greenwald* v. *United States*, 102 C.Cls. 272 (1944) and *Gargaro* v. *United States*, 109 C.Cls. 528, (on demurrer, 1947), 114 C.Cls. 704 (decision on merits, 1949). In both of these cases the United States was the losing party and in neither did the United States file a Petition for Certiorari in this court. It is evident that the Solicitor General of the United States did not believe that the question of law involved was of sufficient importance to warrant the filing of a Petition.

The instances in which the law here involved would be applied to facts similar to these here presented have been and would be infrequent and also of no great significance from an economic point of view.

Petitioner claims that an issue of importance in the administration of the income tax law is presented in the instant case, because tax accounting must be on an annual basis, and if the law, as announced by the Court of Claims in this case, would be permitted to stand, the entire revenue of the United States would have havoc wreaked upon it.

This contention, to speak mildly, is the product of a vivid imagination. Of course, the revenues of the United States must be determined on an annual basis and that is exactly what respondent is contending for and nothing in the opinion below contravenes this principle. That tax accounting of the United States must be on an annual basis means no more than that a taxpayer's annual tax shall be based upon events which occur entirely within the tax year. That proposition is not violated by the decision below. All of the events which deprived the excess bonus received by the respondent of its character as taxable income, occurred in 1944. The decision of the Circuit Court of Cook County, Illinois, in 1946 merely recognized and confirmed what actually occurred in 1944. This has been discussed and need not be repeated. It is clear that the excess bonus which the respondent received in 1944 was not income when it was received in 1944; if it was not income in 1944, the income tax which respondent paid on it for 1944 should not have been paid and should be refunded to him.

Petitioner's alarm that, if the decision below is permitted to stand, taxes would remain unpaid until a determination of whether income received can be retained, is unwarranted by the facts of this case. In this case respondent paid his taxes when the excess bonus was received and did not ask the Government to wait. Now that the error in payment of such taxes has been discovered, respondent is simply asking to have refunded to him the taxes which he was not obligated to pay in the first instance.

The income tax law itself is replete with instances which would wreck more havoc on the revenue of the United States than would the application of the law laid down by the Court of Claims in this case. For instance, if A in March, 1945 files his income tax return for 1944 and makes

a clerical error in that return, or includes in his income for 1944 that which is not income, or excludes from his income for 1944 that which is income, it is his duty and it is the duty of the Commissioner of Internal Revenue to correct the mistake. The result is that A, when the mistake is discovered, pays an additional tax for 1944 or is refunded part of the tax he paid for 1944. He does not pay an additional tax or make a deduction from his income for the year in which the mistake is discovered.

In 1945, when the Company discovered the mistake it had made, it filed an amended 1944 income tax return and paid an additional tax (R. 9). Respondent paid income tax upon the entire compensation received by him in 1944, including the excess bonus for that year. Had the Company waited until the excess bonus had been repaid to it in December 1946 and had it attempted to include the money repaid in its 1946 return, and at the same time to have stood by its original 1944 income tax return, would the petitioner have approved? It certainly would not have! Under what theory of consistency, fairness and justice can the petitioner take the position that it was entitled to the additional income tax paid by the Company for 1944, but that the respondent here is not entitled to a refund of the taxes he paid for 1944 upon the money received by him as the result of a mistake, and which, when he received it, he was under the unconditional obligation to return, and which he did return?

The Court below found that the agreement between the respondent and the Company was that the respondent's compensation in 1944 was 10% of the net profits of the Company *after* taxes (R. 7, 9). Therefore, when the respondent received the excess bonus only one of two possibilities existed: Either (1) respondent embezzled the excess

bonus, because he caused the Company to pay it, and he received it, knowing that the agreement between him and the Company was that his bonus was to be computed *after* taxes; or (2) he caused the Company to pay it, and he received it, as the result of a mistake by the Company and by himself individually, the mistake being that *at that time* both the Company and the respondent believed the agreement was that the respondent's bonus was to be computed *before* taxes, whereas in fact the agreement was that the bonus was to be computed *after* taxes. Upon the authority of *Commissioner* v. *Wilcox*, 327 U.S. 404, if respondent embezzled the excess bonus, he is entitled to a refund. It would indeed be an anomaly if respondent were to be entitled to a refund if he embezzled the excess bonus, but not entitled to it if he received it as a result of an honest mistake. That would hardly be fair or just or sensible.

From every point of view of the equities of the situation, as well as the law, the respondent is entitled to the refund to which the Court of Claims said he was entitled.

CONCLUSION.

For the foregoing reasons, it is respectfully submitted that the Petition for a Writ of Certiorari should be denied.

Respectfully submitted,

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November, 1950.